



Corporate Profile

Cochrane Oil & Gas Ltd. is a Canadian Natural Resource Company with its headquarters located in Calgary, Alberta. The Company's principal activities are exploring for and producing oil and gas in Alberta, Saskatchewan and several areas of the United States. The Company is also engaged in exploring for gold in northwestern Ontario and base metals and silver in British Columbia. The Company's common shares are listed on the Alberta Stock Exchange and trade under the symbol COG.

Highlights

Revenue — Increased from \$2,575,097 in 1984 to \$3,696,289 in 1985 — increase of 44%.

Funds generated from operations — increased from \$71,362 in 1984 to \$548,882 in 1985.

Company operates 165 producing oil and gas wells.

Annual Meeting

The Annual Meeting of Cochrane Oil & Gas Ltd. will be held at 10:00 a.m. on Thursday, July 10, 1986 in the Glengarry Room, Calgary Convention Centre, 120 - 9th Avenue S.E., Calgary, Alberta.

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Corporate Information

Head Office

2100 First Canadian Centre
350 - 7th Avenue S.W.
Calgary, Alberta T2P 3N9
Telephone: (403) 233-7100

Bankers

The Bank of Montreal
Calgary, Alberta

Canadian Commercial Bank
Calgary, Alberta

Solicitors

Macleod Dixon
Calgary, Alberta

Burnet Duckworth & Palmer
Calgary, Alberta

Auditors

Thorne Riddell
Calgary, Alberta

Transfer Agent and Registrar

The Canada Trust Company
Calgary, Vancouver,
Regina, Winnipeg

Stock Exchange

Alberta Stock Exchange
Stock Symbol — COG

Directors

George Isfan, Cochrane, Alberta
Arthur Hironaka, Calgary, Alberta
David Craig, Calgary, Alberta
Ian H. Mackay, Calgary, Alberta
Edward Bamlett, Calgary, Alberta

Officers

George Isfan, President and
Chief Executive Officer
Arthur Hironaka, Vice-President —
Secretary/Treasurer
David Craig, Vice-President —
Engineering and Production
Ronald D. Reddekopp, Drilling and
Production Manager
B. John Schmidt, Controller

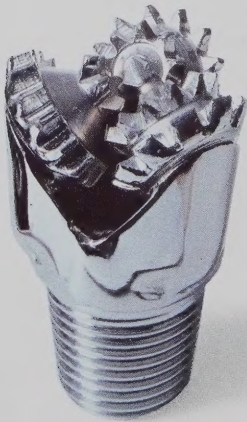
To the Shareholders

The Company experienced only a modest rate of growth in 1985, after a large increase in property acquisition in the previous year. Gross revenue increased by \$1.12 million dollars as projected, and over \$700,000 dollars of long-term bank debt was repaid in 1985. Funds generated from operations prior to depreciation and depletion were \$548,882, but after adjusting for taxes and non-cash items, the Company incurred a net loss of \$492,808 for the year.

Cochrane's income is derived almost totally from natural gas sales and gas processing. As a result, our cash flow in 1986 is not expected to drop as dramatically as that experienced by companies whose production is mainly oil. In fact with a probable continued strong demand for gas, a number of producers with shut-in reserves in the Armada, Eyremore, Majorville areas have requested space for their gas in our processing facilities. We are therefore looking at another major expansion of the Armada facilities to accommodate the newly dedicated reserves for processing.

The Company was successful in having 7 gas wells, 1 oil well and 2 dry and abandoned wells drilled primarily on its own lands at virtually no cost to the Company. The Company also acquired a large interest in 4 low productivity oil wells and was successful in purchasing several sections of land at various crown sales.

The Company continued an exploration program on the 140 gold claims it holds at Manitou Lakes in northwestern Ontario and has delineated several gold-bearing zones which contain sufficient gold to warrant a detailed drilling and bulk sampling program.



Several major mining companies have requested permission to do an on-site inspection of the ground before committing to a major exploration program. Spring break-up normally occurs in early May in this area and we expect to conclude a long-term agreement with a large company by early June. The claims are all in good standing through 1986 or longer.

The dramatic slide in oil prices has the entire industry in a turmoil and has prompted financial institutions to take an extremely conservative and pessimistic view of the future. Although the Company does carry a relatively heavy debt load, we have had excellent co-operation from our major lender, the now defunct Canadian Commercial Bank. As long as the Company continues to service its loan at the CCB (which constitutes 80% of our outstanding debt) the Company and the Bank can maintain their excellent working relationship in 1986. This relieves the Company from having to make an immediate banking change in these unstable times and permits us to consolidate and expand our position in the gas processing field. The Company is also poised to engage in a multi-well oil development project in southeast Saskatchewan as soon as oil prices stabilize. These projects alone will contribute to a significant increase in income for 1986 which will in turn give the Company sufficient cash flow to also complete several gas development drilling projects that are now in hand. We do not foresee any major decrease in gas prices or sales volumes and are of the opinion that because of the slowdown in U.S. drilling, that virtually unlimited gas export contracts will be available much sooner than previously anticipated. While oil is a commodity that can be economically transported around the world, the natural gas market in North America can only be serviced by U.S. and Canadian supplies. Less expensive oil supplies will not displace natural gas in most of the markets it now serves. The supplies of natural gas in the U.S. have most definitely declined and with a continuing shutdown of the industry, we expect demand to far outstrip supplies in the near term. We believe that Cochrane will be in an excellent position to benefit from the upcoming demand for natural gas both from a reserves base point as well as enjoying a very large increase in third party processing revenue.

SUBMITTED ON BEHALF OF THE BOARD,

Handwritten signature of George Isfan.

GEORGE ISFAN
President

May 1986

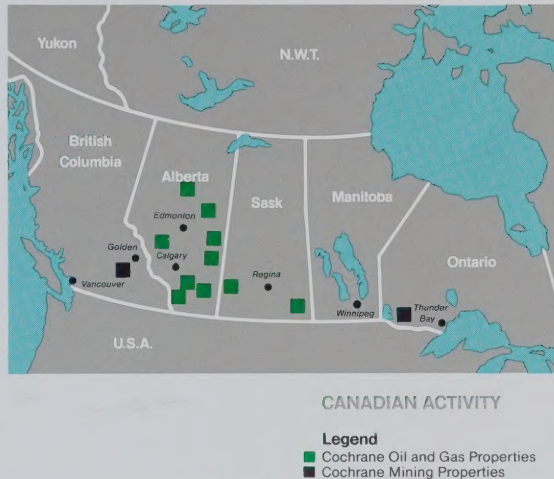
Exploration and Development

In 1985 Cochrane concentrated much of its activity towards getting most of the approximately 165 wells it operates on production, acquiring some offsetting lands and drilling development wells. A large variety of plays were investigated and several were selected for development in 1986. Some crown land was purchased in the Armada-Eyremore area and a successful Bow Island gas well drilled on one section with another offsetting well scheduled in mid 1986.

Cochrane participated in an oil play in the Provost area of eastern Alberta and acquired some freehold oil lands in southeastern Saskatchewan. Up to 7 or 8 development oil wells are scheduled on these properties in 1986, which should increase Cochrane's daily net oil production from about 50 bbls per day to about 250 bbls per day.

One of Cochrane's principal assets are the gas gathering and processing facilities it operates in the Armada area. The system gathers gas from the Armada, Enchant areas in the south to the Majorville area some 40 miles to the north. The compression and refrigeration plant is located at Lsd 1-18-17-18-W4M and sales gas is delivered to a Nova metering station at Scandia in Twp. 16, Rge. 16, W4M.

The facilities are presently capable of handling about 22 million cubic feet per day with 1,000 bbls of condensate storage at the plant site. About 8 MMCF/D out of the current throughput of about 15 MMCF/D is sold on Cochrane's contracts.



With the downfall in oil prices, a number of gas producers have requested space in Cochrane's facilities to market some of the estimated 100 BCF of shut-in gas reserves in the large area serviced by these facilities. Cochrane has engaged an engineering firm to design additional facilities to remove CO₂ and H₂S from an expected 5 - 10 million cubic feet per day new gas production and expects to be processing a total of about 25 million cubic feet per day by the last quarter of 1986. Gross income from gathering and processing is expected to reach about \$350,000 per month by late 1986, and Cochrane operates and retains a 50% interest in the facilities. The upgrading of the system is expected to cost Cochrane about \$0.75 million dollars for its share of the costs.

Manitou Lakes Area, Ontario

Cochrane retains a 94% working interest in some 140 claims (5,600 acres) in the Manitou Lakes area of northwestern Ontario. Some geophysical work was combined with a large geological mapping and sampling program in late summer of 1985.

At least 3 or 4 gold bearing anomalies are now targeted for drilling and 1 or 2 shows now warrant bulk sampling. Some grab sample assays ran from 0.03 to 0.25 and up to 0.5 oz gold per ton. The original volcanic and sedimentary beds which were metamorphosed into hard, dense rock appear to have considerable lateral continuity and thickness, thus allowing for adequate tonnage to warrant mining if an economic grade is established.

At least three major mining companies with land holdings in the area have requested the right to conduct an on-site inspection of Cochrane's claims immediately after spring break-up. The work completed in 1985 consisted of some geophysical surveys to confirm previous findings and a detailed geological map over most of the ground. The results of assays and geochemical analyses of several hundred samples further confirmed previous indications of the presence of potentially economic grades of gold in several anomalies. These anomalies are now sufficiently defined to warrant drilling and, in several cases, a bulk sampling program is recommended.

The next phase of exploration will, therefore, largely consist of some detailed geophysics to pinpoint drill targets and both shallow and intermediate depth drilling to confirm previous results.

Some of the gold discovered to date is finely disseminated or associated with sulphides, but some free gold has been found scattered through the metamorphosed volcanic and sedimentary rocks. These occurrences are best evaluated by bulk sampling since a relatively small diameter core can produce either an anomalously low or high assay reading depending on how much free gold is captured in the core. Several areas are therefore scheduled for a bulk sampling program to reliably determine the amount of gold present.

Cochrane expects to enter into an option agreement with one or more of the interested mining companies by mid year with a drilling program slated to commence by late summer.

Crystal Creek, British Columbia

Most of the Company's large mining claim holdings that surround the former lead, zinc, silver producing Ruth Vermont mine are still in good standing. The Company has recently entered into discussions with the new owner of the mine to determine the feasibility of doing more exploratory work on the Company's lands.



The Company recorded a gross revenue of \$3,696,289 in 1985 which is an increase of \$1,121,192 or about 44% over that earned in 1984. The increase is primarily the result of about a one million dollar increase in oil and gas sales along with higher processing revenue over 1984.

Cash flow generated from operations amounted to \$548,882, however, after adjusting for non-cash items and taxes, the Company incurred a net loss of \$492,808 or 6 cents per share for the year.

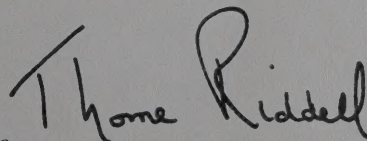
The Company has written down its U.S. oil and gas properties by \$1,289,596 (Canadian dollars) due mostly to the large decrease in oil prices experienced worldwide. Since most of the Company's properties in Canada are producing natural gas wells and processing facilities, and inasmuch as most of these fields are dedicated under long-term gas sales contracts, it was not deemed necessary to write down the value of our Canadian properties.

Not reflected in the 1985 year end statement but implemented in the first and second quarters of 1986 has been an ongoing reduction in overhead. This has been achieved by cuts in staff, salaries and benefits which will exceed \$300,000 in 1986 and will exceed \$400,000 in 1987. Other operating reductions will be in the areas of legal, audit and office operating costs which will further help to reduce overhead.

To the Shareholders of
Cochrane Oil & Gas Ltd.

We have examined the consolidated balance sheet of Cochrane Oil & Gas Ltd. as at December 31, 1985 and the consolidated statements of earnings, deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1985 and the result of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied, after giving retroactive effect to the change in the method of accounting for petroleum and natural gas operations as described in note 3, on a basis consistent with that of the preceding year.



Calgary, Alberta
April 14, 1986

Chartered Accountants



Consolidated Balance Sheet

as at December 31, 1985

ASSETS

CURRENT ASSETS

Cash and term deposits
Accounts receivable
Due from shareholders
Deposits and prepaid expenses

	1985	1984
Cash and term deposits	\$ 404,701	\$ 249,537
Accounts receivable	1,631,260	3,055,263
Due from shareholders	15,531	8,379
Deposits and prepaid expenses	68,623	41,103
	<u>2,120,115</u>	<u>3,354,282</u>

RECEIVABLE ON SHARE PURCHASE OPTION

PLAN (note 7(e))

NOTE RECEIVABLE (note 10(b))

FIXED ASSETS (note 4)

OTHER ASSETS

PLAN (note 7(e))	—	25,000
NOTE RECEIVABLE (note 10(b))	856,000	900,000
FIXED ASSETS (note 4)	14,749,921	15,147,961
OTHER ASSETS	8,000	10,000
	<u>\$17,734,036</u>	<u>\$19,437,243</u>

LIABILITIES

CURRENT LIABILITIES

Accounts payable and accrued liabilities
Bank production and demand loans (note 5)

Accounts payable and accrued liabilities	\$ 2,113,540	\$ 3,911,889
Bank production and demand loans (note 5)	9,166,496	—
	<u>11,280,036</u>	<u>3,911,889</u>

LONG-TERM DEBT (note 5)

GAS PRODUCTION PREPAYMENTS (note 6)

DEFERRED INCOME TAXES

LONG-TERM DEBT (note 5)	—	8,176,480
GAS PRODUCTION PREPAYMENTS (note 6)	473,767	589,583
DEFERRED INCOME TAXES	750,206	1,052,706

SHAREHOLDERS' EQUITY

CAPITAL STOCK (note 7)

Preferred shares

Common shares

DEFICIT

Preferred shares	3,945,500	3,945,500
Common shares	5,060,044	5,043,794
DEFICIT	<u>(3,775,517)</u>	<u>(3,282,709)</u>
	<u>5,230,027</u>	<u>5,706,585</u>
	<u>\$17,734,036</u>	<u>\$19,437,243</u>



FUTURE OPERATIONS (note 2)
CONTINGENCIES AND COMMITMENTS (note 10)
SUBSEQUENT EVENT (note 11)

Approved by the Board

George J. Jagan
A. Hunsche

Director

Director

Consolidated Statement of Earnings



year ended December 31, 1985

	1985	1984
REVENUE		
Petroleum and natural gas sales	\$ 2,465,050	\$ 1,458,050
Processing revenue	994,420	825,145
Less internal processing fees	(261,058)	(120,677)
	733,362	704,468
Interest and other	497,877	412,579
	3,696,289	2,575,097
EXPENSES		
Operating	693,104	450,478
Processing and transmission fees	261,058	120,677
Plant operating costs	279,895	141,533
Interest — long-term debt	972,339	591,074
— other	49,766	196,568
General and administrative	530,560	567,207
Professional and consulting fees	271,350	356,198
Depletion and depreciation	1,344,190	378,287
Other	89,335	80,000
	4,491,597	2,882,022
Loss before undernoted items	(795,308)	(306,925)
Income Taxes		
Current	94,700	195,000
Deferred (reduction)	(302,500)	524,200
	(207,800)	719,200
Loss before extraordinary item	(587,508)	(1,026,125)
Reduction of income taxes from the application of loss carry-forwards	94,700	195,000
NET LOSS	\$ (492,808)	\$ (831,125)
PER COMMON SHARE, based on the weighted average number of shares outstanding		
Loss before extraordinary item	\$(.08)	\$(.19)
Loss for the year	\$(.06)	\$(.15)



Consolidated Statement of Deficit

year ended December 31, 1985

	<u>1985</u>	<u>1984</u>
BALANCE AT BEGINNING OF YEAR, AS PREVIOUSLY REPORTED	<u>\$ (1,480,313)</u>	<u>\$ (1,114,988)</u>
Adjustment of prior year's taxes (note 1 (f))	(512,800)	—
Adjustment for change in the method of accounting for petroleum and natural gas operations (note 3)	<u>(1,289,596)</u>	<u>(1,336,596)</u>
As restated	(3,282,709)	(2,451,584)
LOSS FOR THE YEAR	<u>(492,808)</u>	<u>(831,125)</u>
BALANCE AT END OF YEAR	<u>\$ (3,775,517)</u>	<u>\$ (3,282,709)</u>



Consolidated Statement of Changes in Financial Position



year ended December 31, 1985

	<u>1985</u>	<u>1984</u>
WORKING CAPITAL DERIVED FROM		
Operations		
Loss for the year	\$ (492,808)	\$ (831,125)
Items not involving working capital		
Depletion and depreciation	1,344,190	378,287
Deferred income taxes	(302,500)	524,200
Other	89,335	80,000
	<u>638,217</u>	<u>151,362</u>
Long-term debt	1,703,026	8,176,480
Note receivable	44,000	—
Capital stock	41,250	4,939,806
Other assets	2,000	—
Proceeds on sale of fixed assets	—	3,000,000
	<u>2,428,493</u>	<u>16,267,648</u>
WORKING CAPITAL APPLIED TO		
Fixed assets	1,035,485	3,777,291
Current portion of production and demand loans	9,166,496	—
Repayment of long-term debt	713,010	—
Gas production prepayments	115,816	22,798
Acquisition of Limited Partnerships	—	9,945,984
Note receivable	—	900,000
	<u>11,030,807</u>	<u>14,646,073</u>
INCREASE (DECREASE) IN WORKING CAPITAL POSITION	(8,602,314)	1,621,575
WORKING CAPITAL DEFICIENCY AT BEGINNING OF YEAR	(557,607)	(2,179,182)
WORKING CAPITAL DEFICIENCY AT END OF YEAR	<u>\$ (9,159,921)</u>	<u>\$ (557,607)</u>



Notes to Consolidated Financial Statements

year ended December 31, 1985

1. Accounting Policies (see also note 2)

(a) Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, 200316 Holdings Ltd., and Cochrane Oil & Gas Inc.

(b) Petroleum and Natural Gas Operations

The Company follows the full cost method of accounting for petroleum and natural gas operations whereby all costs of exploration for and development of petroleum and natural gas reserves are capitalized on a country-by-country cost centre basis. Such costs include land acquisition costs, geological and geophysical expense, carrying charges of non-producing property, costs of drilling both productive and non-productive wells, and overhead expenses related to exploration and development activities. These costs and the gas processing plant and facilities are depleted using the unit of production method based on estimated proven reserves of petroleum and natural gas as determined by the Company.

The Company's capitalized costs less accumulated depletion and depreciation in each cost centre are limited to an amount equal to the estimated value of future net revenues from estimated proven reserves (based on current prices and costs as at the balance sheet date).

Substantially all of the Company's exploration and production activities are conducted jointly with others. These consolidated financial statements reflect only the Company's proportionate interest in such activities.

(c) Mining Claims

Mining claims are recorded at the original cost of all claims acquired in each area of interest. Exploration and other expenditures pertaining thereto have been deferred and will be amortized, together with the cost of the related mining claims, against production from future mining operations. If any claims in an area of interest are surrendered, the cost of the claims and the related exploration expenses will be charged to earnings.

All of the mining claims are in the exploratory and development stage and a determination has not yet been made whether these properties contain reserves that are economically recoverable. The recoverability of the amounts shown for mining claims and deferred expenditures are dependent upon the existence of economically recoverable reserves and upon future profitable production.

(d) Depreciation

Depreciation is provided on the diminishing balance basis at rates which will amortize the assets over their estimated useful lives.

(e) Foreign Currency Translation

All monetary assets and liabilities denominated in U.S. currency are translated into Canadian dollars at the rate of exchange in effect at the balance sheet date. Other assets are translated at historical exchange rates. Revenue and expense items (excluding depreciation and depletion which are translated at the same rates as the related assets) are translated at the average rate of exchange for the period. Exchange gains and losses are included in earnings for the year.

(f) Comparative Accounts

Earnings for the year ended December 31, 1984 have decreased by \$512,800 (\$.05 per share) from the amount previously reported to reflect an increase in the Company's tax provision as the results of adjustments to the tax returns.

Certain of the 1984 comparative accounts have been reclassified to conform with the financial statement presentation adopted in 1985.

2. Future Operations

The Company is presently reviewing its repayment terms with its principal banker in light of existing collateral security, present worth and cash flow margins to determine appropriate repayment schedules. Subsequent to December 31, 1985, the Company's principal banker agreed to temporarily suspend the scheduled repayments on the bank demand loan for 1986 in light of the Company's future projections of cash flows.

These financial statements are prepared on the basis that the Company will reach a satisfactory refinancing agreement with the bank and will continue to operate with the bank's support for the next fiscal period ended December 31, 1986. A failure to continue as a going concern would require that these financial statements be prepared on a liquidation basis which could differ from the going concern basis.

3. Changes in Method of Accounting for Petroleum and Natural Gas Operations

Prior to January 1, 1985 the Company accumulated costs related to the exploration and development of petroleum and natural gas reserves on a North American cost centre basis. Such costs were depleted using the unit of production method based on estimated proven reserves.

During the current year the Company significantly reduced its petroleum and natural gas operations in the United States. This necessitated a splitting of its North American cost centre in order to appropriately reflect the consolidated operating results of the Company on a country-by-country basis. Accordingly, effective January 1, 1985, the Company adopted on a retroactive basis, the method of accounting as described in note 1(b).

The change in accounting had the effect of decreasing the loss for the year ended December 31, 1985 by \$111,000 (\$.02 per share). The December 31, 1984 accounts have been restated, from those previously reported, to give retroactive effect to this change in accounting and the effect was to reduce the loss for the year ended December 31, 1984 by \$47,000 (\$.01 per share). The deficit at January 1, 1984, has been charged with \$1,336,596 being the cumulative effect of the change in accounting at that date.

4. Fixed Assets

	1985			1984
	Cost	Accumulated Depreciation and Depletion	Net	Net
Petroleum and natural gas leases and rights including exploration, development and equipment thereon	\$11,704,393	\$1,691,939	\$10,012,454	\$10,167,328
Gas processing plant and facilities	4,147,498	448,845	3,698,653	4,012,067
Office equipment	187,397	71,562	115,835	124,597
Leasehold improvements	153,924	54,459	99,465	130,250
	<u>16,193,212</u>	<u>2,266,805</u>	<u>13,926,407</u>	<u>14,434,242</u>
Mining claims	162,000	—	162,000	162,000
Drilling and camp equipment	18,804	17,836	968	1,383
Deferred expenditures	660,546	—	660,546	550,336
	<u>841,350</u>	<u>17,836</u>	<u>823,514</u>	<u>713,719</u>
	<u>\$17,034,562</u>	<u>\$2,284,641</u>	<u>\$14,749,921</u>	<u>\$15,147,961</u>

During the year the Company capitalized \$292,550 (1984 — \$ Nil) in overhead costs related to exploration and development activities.

5. Long-Term Debt

	1985	1984
Bank production loan	\$1,638,830	\$2,056,353
Bank demand loan	7,527,666	2,291,776
Bank operating loan	—	3,828,351
	<u>9,166,496</u>	<u>8,176,480</u>
Current debt	<u>9,166,496</u>	<u>—</u>
	<u>\$ —</u>	<u>\$8,176,480</u>

The bank loans bear interest from 1 $\frac{1}{4}$ % to 1 $\frac{1}{2}$ % above the bank's prime lending rate. The loans are evidenced by demand promissory notes and are secured by the Company's petroleum and natural gas properties and fixed and floating charge debentures.

The Company is presently reviewing the repayment terms of its bank loans with its bankers. Based upon present projections of the Company's capacity to make interest and principal repayments, revisions to established repayment schedules may be required. The entire amount of the bank loans have been included in current liabilities; however, if repayment negotiations are successful and a favourable revision to the repayment schedules is received, the accompanying consolidated financial statements would be affected by the reclassification of the amount of any repayments deferred in 1986 from current liabilities to long-term debt.

6. Gas Production Prepayments

Amounts received for annual contracted natural gas volumes not taken by pipeline purchasers are deferred and will be recognized as revenue when deliveries are made over a ten year period commencing November 1, 1984.

7. Capital Stock

(a) Authorized

50,000,000 Common Shares without par value.

50,000,000 Common Shares without par value and non-voting.

10,000,000 First Preference Shares with a minimum issue price of \$10 per share, to be issued in series at prices and terms to be determined by the Company's Directors.

10,000,000 Second Preference Shares with a minimum issue price of \$10 per share, to be issued in series at prices and terms to be determined by the Company's Directors.

(b) Issued

(i) Preferred Shares

As at December 31, 1985 and 1984 the Company's outstanding preferred shares were as follows:

	Number of Shares	Amount
First Preference Shares, Series A	220,000	\$2,200,000
First Preference Shares, Series B	125,280	1,252,800
Second Preference Shares, Series A	75,000	492,700
		<u>\$3,945,500</u>

(ii) Common Shares

Changes in the Company's outstanding Common share capital during the year were as follows:

	Number of Shares	Amount
Balance, December 31, 1984	6,711,035	\$5,043,794
Issued on stock dividend		
— First Preference Shares, Series A	374,000	—
— First Preference Shares, Series B	155,367	—
To be issued		
— for exploration and development expenditures less related Petroleum Incentive Program payments of \$8,750	142,850	41,250
To be cancelled		
— on employee share option plan	(50,000)	(25,000)
Balance, December 31, 1985	<u>7,333,252</u>	<u>\$5,060,044</u>

- (c) The 8% Cumulative Redeemable Convertible First Preferred Shares, Series A and B are redeemable at \$10.20 per share after February 28, 1987 and are convertible, at any time, into common shares at a price of \$1.25 per share to March 1, 1989.

The Company may elect to issue common shares in lieu of cash dividends on the First Preferred Shares, Series A and B. The common shares issued under this option will be at a price based upon the trading price of such shares on The Alberta Stock Exchange and have been treated for accounting purposes as a stock dividend and, accordingly, no value has been attributed thereto.

The Retractable Convertible Second Preferred Shares Series A are retractable at \$18.75 per share after March 15, 1990 and are convertible at any time, into common shares at a price of \$.80 per share to February 16, 1990.

- (d) The Company has issued the following share purchase options:

- (i) 133,750 shares under the Company's Employee Share Purchase Plan at prices varying from \$.34 and \$.59 per share expiring in 1987 and 1989, respectively.
- (ii) 351,923 shares to a consultant of the Company at a price of \$.52 per share expiring in 1988.

- (e) The receivable on the Share Purchase Option Plan related to the issuance to employees, under the terms of a Share Purchase Option Plan, of 50,000 common shares of the Company. The shares were held by The Canada Trust Company to be released upon payment for the shares up to May 22, 1985. The employees did not exercise their options and the Company has reflected in its accounts the cancellation of the 50,000 common shares.

8. Income Taxes

- (a) As at December 31, 1985, the Company had the following deductions available to reduce future years' earnings for income tax purposes, the effect of which has not been recorded in the accounts (all subject to final determination by taxation authorities):
- (i) Canada
Loss carry-forwards (expiring in varying amounts beginning in 1985) \$ 630,000
 - (ii) United States
Loss carry-forwards (expiring in varying amounts beginning in 1995) \$1,292,000
- (b) Fixed assets include unamortized costs of approximately \$3,113,000 which are not deductible for income tax purposes by the Company.
- (c) Income tax expense differs from amounts which would be obtained by applying the Canadian basic federal income tax rate of 46% to the respective years earnings before income taxes. The difference between the computed "expected" tax provision and the actual tax provisions are summarized as follows:

	1985	1984
Computed "expected" tax recovery	\$(365,800)	\$(141,200)
Non-deductible Crown charges net of provincial credits	103,100	67,500
Non-allowable depletion of costs of acquired assets with no tax basis	138,500	16,100
Federal resource allowance	(122,200)	(113,800)
Provincial and state income taxes less federal abatements and surtaxes	2,000	14,100
Difference in effective rate of previously accumulated timing differences	(15,000)	—
Other non-deductible expenses	51,600	36,800
Gain on sale of fixed assets for tax purposes	—	722,000
Partnership income	—	117,700
	<u>\$(207,800)</u>	<u>\$ 719,200</u>

9. Other Information

The total remuneration paid to directors and senior officers of the Company which by statute includes the five highest paid employees amounted to \$383,437.

Certain officers and directors participate in certain joint ventures with the Company on the same or similar terms as other participants.

10. Contingencies and Commitments

- (a) The Company has guaranteed the obligations of a company to a maximum of \$199,000 as part of the terms of their 20% investment in that company. The shares representing their 20% investment have been pledged as additional security on that company's loans.
- (b) The note receivable is secured by certain fixed assets and bears interest at prime plus 1½%. During 1985 the holder of the note ceased making principal and interest repayments. Presently the Company is attempting to recover either the amounts owing in respect of the note or the security pledged by the borrower under the terms of the note.
- (c) The Company has lease agreements in respect of office premises for which future minimum payments for the next five years are approximately as follows:

1986	\$ 87,955
1987	87,955
1988	118,111
1989	49,213
	<u>\$343,234</u>

11. Subsequent Events

Subsequent to December 31, 1985 petroleum and natural gas prices have declined substantially. It is the Company's policy to perform a ceiling test on an annual basis based on prices in effect at the balance sheet date. As a result of the current price decline a write-down of the carrying value of the petroleum and natural gas properties may be required should these depressed prices continue through to the Company's next fiscal year end.

Credits

Design and Production — Art Directions of C.L. Belyea Limited
Photography — John Bagshaw Photography Ltd.
Printed in Canada — Style-Craft Printing Ltd.

